No. 445

In the Supreme Court of the United States

October Term, 1942

BOWLES, Price Administrator,

v.

CONSOLIDATED, etc., Petitioner,

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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BONWIT TELLER, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 30–41) is reported in 46 B. T. A. 978. The opinion of the Circuit Court of Appeals (R. 126–130) is reported in 136 F. 2d 978.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 28, 1943 (R. 141). A petition for rehearing was denied on the same day (R. 140). The petition for a writ of certiorari was filed on October 21, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Ju-

dicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether under Section 23 (l) of the Revenue Act of 1938 the petitioner is entitled to a deduction from its gross income for the taxable year ended January 31, 1939, for depreciation of permanent leasehold improvements installed by the petitioner's predecessor.

STATUTE AND REGULATIONS INVOLVED

The applicable statute and regulations are set forth in the Appendix, *infra,* pp. 12–15.

STATEMENT

The pertinent facts found by the Board of Tax Appeals may be summarized as follows:

Bonwit Teller & Company, the petitioner's predecessor (hereinafter called the old company), leased from 721 Fifth Avenue Corporation at a rental of $475,000 a year certain improved property in New York City, known as 721 Fifth Avenue, for a period commencing May 1, 1930, and ending July 31, 1951 (R. 30–31). In 1931 the old company made certain permanent improvements to the building located on the demised premises at a cost of $618,964.64. Until July 1, 1933, these improvements, which had an estimated life of twenty years, were depreciated by the old company on its income tax returns at the rate of five percent per annum. (R. 31.)

Due to financial difficulties resulting from the depression, the old company later in 1931 succeeding in obtaining a reduction of the fixed annual rental of the premises to $300,000 (R. 31). Financial difficulties continuing, the old company and 721 Fifth Avenue Corporation executed a new lease on December 14, 1932, for the period from that date to September 30, 1938.[1] The new lease provided for a rental of five percent of the old company's receipts from sales on the premises with a fixed minimum of $100,000 per year, but the lessor had the right to terminate the lease on ninety days' notice. Concurrently with the execution of the new lease, 721 Fifth Avenue Corporation placed the premises in control of its mortgagee, the City Investing Company, and the latter thereby became entitled to receive all rents from the old company due under the lease of December 14, 1932. (R. 32.)

The financial difficulties of the old company were still not dispelled and its board of directors took action to organize a new corporation for the purpose of taking over all the assets of the old company (R. 32). On July 6, 1933, the petitioner was organized under the laws of New York, as the Commercial Operating Company

[1] The record discloses that the board of directors of the old company adopted a resolution that the original lease, of April 7, 1930, "be surrendered and cancelled" and at the same time authorized the execution of the new lease (R. 117–118).

(R. 30). Somewhat later, the petitioner's name was changed from Commercial Operating Company to Bonwit Teller, Inc. At the same time, the old company's name was changed from Bonwit Teller & Company to Commercial Operating Company. (R. 34.)

Under date of July 25, 1933, as of the close of business on June 30, 1933, the old company transferred to the petitioner, in exchange for shares of the petitioner's capital stock, all of its assets, including "furniture, fixtures, improvements and equipment," except the lease on the demised premises at 721 Fifth Avenue and all other leases. The petitioner assumed the liabilities of the old company except, *inter alia,* liability under the leasehold estates. This transfer was part of a tax-free reorganization resulting in neither profit nor loss to the old company. (R. 33.) Immediately thereafter, the petitioner entered on its books the assets of the old company at the same amounts as they had been carried on the books of the old company, and included among such assets the leasehold improvements. However, in December, 1936, the petitioner's books were rewritten as of July 1, 1933, and the asset item representing the leasehold improvements was written down to the sum of $1. Since the effective date of the transfer of the assets, the petitioner has claimed depreciation on the improvements made by the old company at the same rate

as that claimed by the old company prior to the transfer. (R. 33–34.)

From on or before April 7, 1930, to the date of the transfer, the old company remained in physical possession of the premises and of the improvements from the date of their installation. Since the transfer, the petitioner has continuously occupied the same premises, together with the improvements.[2] At all times material, it has used the premises and improvements in continuing the business previously conducted by the old company. At the date of the transfer, the personnel of the old company became the personnel of the petitioner, and remained so for some time. No lease was executed in favor of the petitioner until December 1937, as hereinafter set forth. (R. 37.)

The old company was adjudged a bankrupt on August 4, 1933. On or about October 10, 1933, the trustee in bankruptcy notified the lessor of the demised premises, 721 Fifth Avenue Corporation, of the trustee's election not to adopt the lease for the benefit of the bankrupt estate. The old company ceased to do business of any kind after the effective date of the transfer of its assets to the petitioner, and was finally dissolved under the laws of New York on December 15, 1937. (R. 34–35.)[3]

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[2] The record shows that the petitioner's occupancy was by arrangement with the mortgagee in possession (R. 62, 96).

[3] The referee in bankruptcy determined that the transfer of assets to the petitioner in exchange for stock was not

In the meantime, on or about April 1, 1936, the mortgage on the demised premises held by the City Investing Company was assigned to the American Company, a wholly owned subsidiary of the Atlas Corporation. The City Investing Company also assigned to the American Company the right to receive all rents from the tenant under the lease of December 14, 1932, and likewise by assignment the American Company became the lessor of the premises. (R. 35.) Thereupon the American Company organized a wholly-owned subsidiary, the Fifty-Six & Fifth Corporation, for the purpose of acquiring the fee simple absolute of the demised premises from 721 Fifth Avenue Corporation. By agreement of March 30, 1937, 721 Fifth Avenue Corporation sold and conveyed the demised premises to the Fifty-Six & Fifth Corporation subject to the rights of the tenants in possession. (R. 36.)

Under date of December 1, 1937, the petitioner and Fifty-Six & Fifth Corporation executed a lease of the premises at a stated rental for a term beginning December 1, 1937, and ending January 31, 1950 (R. 36). Prior thereto the petitioner

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fraudulent and approved an offer of composition providing for distribution of the petitioner's shares to the creditors of the old company. This action was approved by the District Court and on appeal by the Circuit Court. (R. 35.) For the decision of the Circuit Court, see *In re Commercial Operating Corp.*, 77 F. 2d 285 (C. C. A. 2d), certiorari denied *sub nom. Arnold Constable Corp.* v. *Commercial Credit Corp.*, 296 U. S. 616.

had paid to the City Investing Company for the period commencing August 1, 1933, and ending March 31, 1936, "moneys equal to the amount of rent" provided in the lease dated December 14, 1932. Thereafter until November 30, 1937, the petitioner paid like amounts to the American Company. (R. 37.)

At no time has 721 Fifth Avenue Corporation entered on its books the cost or the value of the improvements to the building located on the demised premises made by the old company in 1931, and at no time has 721 Fifth Avenue Corporation made any claim in its income tax returns for depreciation on such improvements (R. 38).

Upon acquisition, the premises were entered on the books of the Fifty-Six & Fifth Corporation at their cost, measured by the consideration of $500,000 paid by it and the amount of the mortgages assumed by it. The total cost to the Fifty-Six & Fifth Corporation so computed was $5,808,894.82. Of this amount $2,219,224.37, or 38.2039 percent (the percentage of the assessed value of the building to the assessed value of land and building), was entered on the books of the Fifty-Six & Fifth Corporation as the cost of the building on the demised premises. On its income tax returns the Fifty-Six & Fifth Corporation has claimed an estimated useful life of the building of twenty-five years from April 1, 1937, and has deducted depreciation at the rate of four percent per annum. (R. 38.)

The Board of Tax Appeals sustained the deficiency assessed by the Commissioner with respect to deductions for depreciation for the year ending January 31, 1939, holding that the petitioner was not entitled to deductions on account of depreciation of the improvements (R. 30, 38–41). The Circuit Court of Appeals affirmed that decision (R. 126–130).

ARGUMENT

Petitioner's claim that it is entitled to a deduction for depreciation on the leasehold improvements installed by its predecessor, the old company, is without merit, and there is no conflict.

1. Petitioner would be entitled to the depreciation deductions claimed only if it had either made a capital investment in the improvements (*Weiss* v. *Wiener,* 279 U. S. 333; *Detroit Edison Co.* v. *Commissioner,* 319 U. S. 98), or if it had acquired the depreciable cost basis of its predecessor in a tax-free reorganization (Section 113 (a) (7) of the Revenue Act of 1938, Appendix, *infra*). It did neither.

There is no question that petitioner made no capital investment in the improvements involved. Those improvements were installed by the old company in 1931 with its own funds. (R. 31, 58.)

Nor did petitioner, as transferee of the old company in the 1933 reorganization, acquire the latter's depreciable cost basis in the improvements. Under the original 1930 lease the old company was

entitled to depreciation deductions based upon the cost to it of the permanent improvements which it had installed during the pendency of the lease. But on December 14, 1932, when the second lease was executed, the old company by cancelling and surrendering the original lease (R. 117–118) lost its right to depreciate its capital investment,[4] for on that date all property rights in the improvements vested in the lessor, who thereby realized taxable gain and thus was entitled to depreciate in the future the property so acquired. See *Helvering* v. *Bruun,* 309 U. S. 461; *Lewis* v. *Pope Estate Co.,* 116 F. 2d 328 (C. C. A. 9th), certiorari denied, 314 U. S. 630; *Gowern's Estate* v. *Commissioner,* 119 F. 2d 83 (C. C. A. 3d). At the time of the 1933 reorganization, therefore, the old company possessed no depreciable cost basis in the improvements which could have been acquired by petitioner.

Moreover, if the old company had continued to retain a depreciable cost basis after executing the new lease of December 14, 1932, petitioner did not acquire that basis from it in the 1933 reorganization. Whatever right the old company may still have had to depreciation allowances, it possessed as a result of its lease. Only if petitioner had ob-

[4] Where the lease terminates before the lessee has fully recovered its capital investment, it then suffers a deductible loss. *New York Cent. R. R. Co.* v. *Commissioner,* 79 F. 2d 247 (C. C. A. 2d), certiorari denied, 296 U. S. 653; *Washington Catering Co.* v. *Commissioner,* 9 B. T. A. 743.

tained from the old company the latter's lease pursuant to the reorganization would it have acquired the old company's depreciable cost basis. This it did not do. On the contrary, in the reorganization of 1933 the lease of December 14, 1932, was expressly excluded from the transfer of the property of the old company to the petitioner, and it was only at the sufference of the lessor and mortgagee that petitioner was permitted the use and enjoyment of the improvements (R. 33).

2. Even if petitioner had acquired from the old company the latter's depreciable cost basis, it lost its right to depreciation deductions on December 1, 1937, when it executed a new lease with the Fifty-Six & Fifth Corporation, which had purchased the premises in 1937 (R. 36). That new lease effectively superseded the December 14, 1932, lease if the latter still had any force or effect. Thereupon, any right to depreciate which petitioner might have possessed passed to the Fifty-Six & Fifth Corporation. The latter has in fact taken depreciation deductions on the basis of the estimated cost to it of the improvements in question (R. 38).

3. The decision in the instant case is not in conflict with the cases relied upon by petitioner. *George H. Bowman Co.* v. *Commissioner,* 32 F. 2d 404 (App. D. C.); *Simons Brick Co.* v. *Commissioner,* 14 B. T. A. 878, affirmed on other grounds, 45 F. 2d 57 (C. C. A. 9th), certiorari denied, 283

U. S. 834, *Rankin* v. *Commissioner,* 17 B. T. A. 1301, affirmed, 60 F. 2d 76 (C. C. A. 6th), and *Elmira Arms Co.* v. *Commissioner,* 7 B. T. A. 703, involved taxpayers who made capital investments in permanent improvements and who continued to exercise during the taxable year the same right of occupancy under which the improvements were made. They are inapplicable where, as here, the taxpayer made no such investment and where the earlier right of occupancy had been terminated (cf. *Gowern's Estate* v. *Commissioner, supra*). Although petitioner here relies upon its relationship to the entity which did make the investment, and its failure to acquire and retain the lease under which the investment was made is decisive.

CONCLUSION

The petition should be denied.

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